

**Additional Improvements Will Better
Focus the Employee Plans Function's
Examinations Workplan on Areas That
Identify and Correct Noncompliance**

August 2002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 16, 2002

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Improvements Will Better Focus
the Employee Plans Function's Examinations Workplan on Areas
That Identify and Correct Noncompliance (Audit # 200110051)

This report presents the results of our review of the Employee Plans (EP) function's annual examination workplan. The objective of this review was to assess the effectiveness of the EP function's examination planning process.

In summary, we found that, with the exception of the Local Classified Issues category, the workplan is structured to enable EP to identify and correct noncompliance within employee benefit plans. Local Classified Issues examinations did not help EP Examinations meet its mission because this category was not designed to focus on areas representing the greatest risk of noncompliance. Our review of recent selections from this category determined that most were not directed to known areas of noncompliance nor were they designed to develop areas of noncompliance. Although these selections provided work to examiners and helped the EP function meet its performance goals, such as "total closures," they were not an effective use of EP's resources and they added unnecessary burden, in terms of time and expense, to taxpayers.

In addition, we determined that Local Classified Issues selections were often employee benefit plans with less than 25 participants. This was not in accordance with the Internal Revenue Service's (IRS) Fiscal Year 2002 Annual Performance Plan, which states that available examination resources would focus on employee benefit plans that cover the greatest number of participants.

Furthermore, our review indicated that EP Examinations' workplan does not include various scenarios upon which to base the selection of additional returns when examination resources are not used to process determination letters.

We noted that the Director, EP Examinations, envisions future examination workplans will contain more specialized work because the EP function has incorporated a market segmentation approach to achieve its mission of identifying and correcting noncompliance.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, has implemented our recommendations by taking the following actions.

- Establishing the Risk Assessment Program and engaging the services of the Research and Analysis staff to ensure that returns selected for examination have a high probability of noncompliance.
- Continually updating the risk assessment data and changing examination focus when warranted, based on the results of examinations, to ensure returns selected for examination further EP's mission of identifying and correcting noncompliance.
- Incorporating language into the workplan guidelines on how to use the number of participants in a plan when selecting returns for examination.

In addition, the EP function is attempting to change the determination letter process to improve the flow of applications by considering 10 possible long-term options. This, along with the possible establishment of a dedicated workforce to process determination letters, will simplify the process for developing the examination workplan.

Management's complete response to the discussion draft report is included as Appendix IV.

Copies of this report are also being sent to the Internal Revenue Service managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Background

The Employee Plans (EP) function within the Tax Exempt and Government Entities (TE/GE) Division has responsibility for ensuring compliance with the Internal Revenue Code (I.R.C.) sections and regulations governing employee benefit plans.¹ Employers or other plan sponsors operate approximately 969,000 tax-qualified employee benefit plans with approximately \$4.1 trillion in assets. Employers or plan sponsors are required to submit an Annual Return/Report of Employee Benefit Plan (Form 5500) or Annual Return of One-Participant Retirement Plan (Form 5500-EZ) each year.

The qualification requirements under the I.R.C. for employee benefit plans are enforced by the EP function. A benefit plan that meets the qualification standards of the I.R.C. is accorded special tax treatment under present law. The employer is entitled to a current deduction for contributions to a qualified employee benefit plan even though the contributions are not currently included in an employee's income. Contributions to a qualified employee benefit plan are held in a tax-exempt trust.

If an employee benefit plan fails to meet the qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have to report benefits on their tax returns. As a practical matter, the EP function rarely disqualifies an employee benefit plan. Instead, it may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.²

The EP function consists of three major program areas, each of which focuses on ensuring employers and plan sponsors are complying with the law: Customer Education and

¹ Employee benefit plans include programs such as pension plans, profit-sharing plans, I.R.C. 401(k) retirement plans, employee stock ownership plans, and stock bonus plans.

² *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* prepared by the Joint Committee on Taxation (JCX-9-02, dated February 25, 2002).

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Outreach (CE&O), Rulings and Agreements (R&A), and Examinations.

- The CE&O Program focuses on helping EP external customers understand their tax responsibilities by developing tailored education programs.
- The R&A Program focuses on up-front compliance programs, such as determination letters. Many employers request a determination letter from the IRS to obtain assurance that the terms of their plans satisfy the qualification requirements. The Determination Letter Program receives priority over other compliance activities because EP is required by law to issue determination letters upon request.
- The Examinations Program seeks to identify and correct noncompliance by conducting focused, efficient examinations; resolving issues at the lowest possible level (to allow employers to identify and correct deficiencies prior to IRS adjudication); and ensuring consistency and fairness in the application of the law.

In April 2000, the TE/GE Division commenced centralizing the EP Examinations Program in Baltimore and established six new area offices,³ replacing the former Key District Office structure. The area offices report to the Director, EP Examinations, located at the new centralized examination site. By making this change, the TE/GE stated it would be in a better position to manage its resources and respond quickly to customer needs.

The EP Examination Planning and Programs (EPP) staff has responsibility for developing the annual workplan guidelines and preparing and monitoring the examination workplan. The workplan shows how resources will be allocated to the various examination categories.

³ The six area offices include Central Mountain (Denver, Colorado); Great Lakes (Chicago, Illinois); Gulf Coast (Dallas, Texas); Mid-Atlantic (Philadelphia, Pennsylvania); Northeast (Brooklyn, New York); and Pacific Coast (Los Angeles, California).

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The EP Examinations' workplans prepared for Fiscal Years (FY) 2001 and 2002 were affected by the number of requests for determination letters expected during these years. The Director, EP Examinations, expected that 63 percent of examination resources would be used to process these determination letters in FY 2002.

We conducted this audit from September 2001 to April 2002 at the National Headquarters Office, the centralized examination site, and the Central Mountain, Great Lakes, Northeast, and Pacific Coast Area Offices. This audit was conducted in accordance with *Government Auditing Standards*; however, we did not verify the accuracy of the data obtained from EP's management information reports.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Our review determined that the EP Examinations' workplan did not ensure that discretionary examination work (primarily the Local Classified Issues category) was effective in identifying and correcting noncompliance. Over half of the available examination resources in FY 2001 were spent auditing employee benefit plans that were primarily compliant. The trend in FY 2002, through the first quarter, was to continue with these same types of examinations.

According to the FY 2002 Examinations' workplan, the EP function expected to close approximately 6,000 employee benefit plan examinations. In FY 2001, EP Examinations closed approximately 11,000 examinations. The reduced level of examination closures expected for FY 2002 reflects the diversion of significant resources to process the anticipated volume of determination letter requests.

**With the Exception of the Local
Classified Issues Category, the
Workplan Should Enable the
Employee Plans Examinations
Program to Meet Its Mission of
Identifying and Correcting
Noncompliance**

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The FY 2002 Examinations' workplan allocated 27,465 workdays for direct examinations,⁴ with the majority of the workdays directed to four major categories. Three of the four are mandatory (non-discretionary) work that examiners will work each year. Some of this work, such as referrals and claims, is dependent on the number that are available for examination. The three non-discretionary categories include:

- **Casework.** These are defined as examinations that arise from known noncompliance activities of taxpayers. Examples include referrals and claims. This also includes the Employee Plans Team Audit that focuses on plans with 2,500 or more participants, among other criteria.
- **Nationwide Examinations.** These are defined as mandatory compliance activities such as examining pension underfunding, issued waivers, and multiemployer plans.
- **Compliance Research Program.** These are defined as projects implemented to document and assess the impact of compliance activities within various market segments. Examinations are selected not because of an issue or line item on the return but to learn about a particular market segment.

The remaining workdays are assigned to discretionary work, which are general examinations that provide flexibility to EP Examinations in years when examiners are needed to process determination letter requests. The category⁵ receiving the largest allocation of these remaining workdays is known as:

⁴ Direct Examination Time includes time actually spent examining a taxpayer's records and returns, time on research or reading issuances dealing with issues involved in the return being examined, travel time incident to the examination, and time devoted to writing the report. It does not include other operational time, such as time spent for employee training and leave.

⁵ The other categories of general examinations are named Training, Sample Result, and General Cases.

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- **Local Classified Issues.** These are defined as examinations based on using the Returns and Inventory Classification System (RICS) to identify potential issues of noncompliance but where the population may be too small to warrant a research sample.

Table 1 shows the allocation of the 27,465 workdays to the various direct examination categories:

Table 1. FY 2002 Direct Examination Budgeted Workdays

Examination Category	Workdays Budgeted	Percentage of Total Direct Exam Time for Each Category⁶
Casework	10,647	39
Local Classified Issues	8,858	32
Compliance Research Program	5,708	21
Nationwide Examinations	1,101	4
Training Cases	891	3
Sample Result Cases	146	.5
General Cases	114	.4
Total	27,465	

Source: FY 2002 Examinations' Workplan

We analyzed EP accomplishment reports, examination data from the RICS, and held discussions with applicable EP personnel to determine if the major categories of the FY 2002 Examinations' workplan are designed to accomplish the EP function's goal of identifying and correcting noncompliance. This goal is also part of the Internal Revenue Service's (IRS) Strategic Plan which states that it is essential that the IRS apply its limited resources where they will be of most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the need to burden those who do comply.

⁶ These percentages do not add up to 100 due to rounding.

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We determined that the three non-discretionary categories of EP Examinations' workplan are focused on identifying and correcting noncompliance within employee benefit plans. The Casework and Nationwide Examinations categories are currently designed to examine the types of employee benefit plans that prior examinations have shown are not always in compliance with the law.

The Compliance Research Program has a different purpose. It is designed to determine the extent of noncompliance within EP's market segments. For example, examiners conduct examinations using statistically valid samples to measure the level of compliance within EP's market segments. If there is a high no change rate (no adjustments are needed to the Form 5500 returns) for examinations in one of the market segments, it is an indication that the benefit plans in that market segment are compliant with the law. If there is some degree of noncompliance requiring changes to the Form 5500 returns, EP can: conduct a follow-up project to identify specific noncompliant areas, incorporate the area of noncompliance into the workplan in one of the non-discretionary examination categories, or notify CE&O about the area of noncompliance identified so it can implement a customer education program.

However, the remaining major category, Local Classified Issues, did not help EP Examinations meet its mission of identifying and correcting noncompliance because this category is not designed to focus on areas representing the greatest risk.⁷ This is evidenced by the 79 percent no change rate for examinations of Local Classified Issues closed during FYs 1997 through 2001.

Table 2 shows the percentage of the examinations for these four categories that resulted in "no change" according to EP accomplishment reports for FYs 1997 through 2001.

⁷ A "no change rate" is the number of employee benefit plans examined and found to be compliant with applicable laws. According to EP's own criteria, a no change rate greater than 80 percent represents an area of low risk, a no change rate less than or equal to 80 percent or greater than or equal to 70 percent represents medium risk, while a no change rate less than 70 percent represents high risk.

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**Table 2. Fiscal Years 1997 through 2001
Employee Plans Examinations Results (Cumulative)**

Category	Total Number of Examinations	Percentage of Examinations With No Change⁸
Casework	8,696	31
Compliance Research Program	27,805	60
Nationwide Examinations	3,713	31
Local Classified Issues	11,078	79

Source: EP Function Accomplishment Reports

Effectiveness of Local Classified Issues condition codes

The Local Classified Issues category consists of condition codes, created by EP, that specify the primary issue for the selection of a return for examination. In FY 2001, there were just over 100 total condition codes, with each of the four geographic areas⁹ having its own set of condition codes. This led to inconsistencies in the types of returns selected for examination within this category. In FY 2002, those condition codes were consolidated into a single, uniform listing of 17 condition codes based on a review by EP management of historical examination information and consideration of their own past experience.

To determine the cause of the high no change percentage for the Local Classified Issues category, we analyzed the

⁸ The remaining examinations were closed with a change to the return, which indicates some degree of noncompliance. For example, 69 percent of the Casework examinations identified some degree of noncompliance on the returns.

⁹ The four geographic areas were Midwest, Northeast, Southeast, and Western.

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examination selections for FY 2001 and the first quarter of FY 2002, with information from the RICS. We determined the total number of selections for each of the condition codes used during those periods. We then compared this information to the results of previous examinations conducted within those condition codes to determine if the prior activity warranted those selections. In addition, we reviewed the condition codes used to determine if they contained issues or characteristics that would enable EP to identify noncompliance within its market segments.

Our review of those recent selections from the Local Classified Issues category determined that most condition codes are not directed to known areas of noncompliance nor are they designed to develop areas of noncompliance.

There were nearly 7,000 Local Classified Issues selections in FY 2001 and approximately 1,450 in the first quarter of FY 2002.

We analyzed approximately 6,900¹⁰ selections made in FY 2001 and determined that nearly 5,100 (74 percent) were not focused towards areas of risk. As of December 2001, we found that approximately 2,700 of these 6,900 selections were examined and closed. Of the 2,700 closed examinations, 91 percent resulted in a no change.

The following is an approximated breakdown of these exceptions and why we believe they did not fulfill the EP function's objective for examinations.

- Approximately 1,300 selections were from condition codes where the previous examinations (as of October 1, 2000) within those condition codes did not indicate noncompliance.¹¹ For example, we took exception to a selection if 200

¹⁰ A total of 6,994 were selected. However, a total of 85 were not considered in our analysis because the condition code field was blank or the condition code was outside the series of codes associated with Local Classified Issues.

¹¹ Our determination was based on at least 75 prior examinations and EP's definition of risk from their risk assessment (see footnote 7).

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previous examinations, within that condition code, collectively had a no change rate of 88 percent.

- Approximately 3,800 selections were general in nature and either contained no criteria or issues to identify potential noncompliance or placed emphasis on the experience level of the examiner, which may not be an indication of noncompliance. For example, employee benefit plans were selected because they were not examined during the last 5 years. This selection criterion did not contain attributes that would identify a pattern of noncompliance.

From our analysis, we concluded that there appeared to be no compliance related justification for spending over half of the available examination resources in this category during FY 2001.

Our review of the approximately 1,450¹² selections made during the first quarter of FY 2002 determined that nearly 800 (53 percent) were made from condition codes where the previous examinations within those condition codes did not indicate noncompliance. In addition, nearly 400 of the 1,450 selections (27 percent) were made from a condition code with a history of 50 previous examinations resulting in a no change rate of 94 percent.

The ineffectiveness of these selections occurred because existing procedures for selecting returns from the Local Classified Issues category did not ensure that returns were selected either from known areas of noncompliance or to develop the extent of noncompliance within an area. The lack of a clear goal or purpose for these examinations led to this ineffectiveness.

As stated earlier, according to the workplan guidelines, Local Classified Issues examinations should be selected to

¹² There were three other selections during this period that were not considered in our analysis because the condition code field was either blank or outside the series of codes associated with Local Classified Issues.

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identify issues of noncompliance where the population may be too small to warrant a research project. Selection criteria for these cases include factors in addition to geographic location and/or case grade. The EPP staff believed that cases are selected from Local Classified Issues condition codes where previous examinations resulted in the lowest no change percentage. As stated earlier, our analysis did not show this. In addition, various EP Examinations management referred to the Local Classified Issues examinations as more general in nature or “filler work.”

Another factor in the ineffectiveness of these examinations could be a competing performance goal. The Local Classified Issues types of examinations helped EP meet its performance goal for “total closures” in FY 2001. EP closed a total of approximately 11,000 examinations in FY 2001, with approximately 6,000 of these being Local Classified Issues closures.

Consequently, EP Examinations resources assigned to examine returns selected as part of this category are not the most effective use of resources. Also, auditing compliant employee benefit plans with little or no indication of noncompliance adds unnecessary burden, in terms of time and expense, to taxpayers.

Employee benefit plan participants affected by Local Classified Issues selections

In addition to our review of the effectiveness of the Local Classified Issues condition codes, we reviewed participant information to determine the number of participants affected by these selections. The IRS' FY 2002 Annual Performance Plan states that available examination resources would focus on employee benefit plans that cover the greatest number of participants.¹³ However, our review of Local Classified Issues examination selections for FY 2001 and the first

¹³ This refers to the size of the employee benefit plan. A plan that covers 100 or more participants is considered a “large plan,” whereas a plan that covers fewer than 100 participants is considered a “small plan.”

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quarter of FY 2002 determined that these selections were often employee benefit plans with less than 25 participants.

We analyzed approximately 8,400¹⁴ employee benefit plans selected in FY 2001 and the first quarter of FY 2002 and found that approximately 4,200 had fewer than 25 participants. These plans represented about 33,200 plan participants, or an average of 8 per plan.

One reason we believe this occurred is because the workplan guidelines did not specify to use the size of the employee benefit plan as a factor when selecting discretionary work. IRS management informed us that another factor in assigning plans with smaller numbers of participants was the grade level of the employee. Smaller plans were assigned to lower graded employees. Nonetheless, the small size of the plans (together with the ineffectiveness of the condition codes) added to the inefficient use of examination resources.

While a majority of the employee benefit plans nationwide have fewer than 10 participants, we believe EP should select plans with the largest possible number of participants when all other selection criteria are equal. For example, EP should select an employee benefit plan with 65 participants, rather than a plan with 2 participants if both plans can be worked by examiners at a particular grade level. This approach would mirror the expectation for the EP Examinations Program as stated in the IRS' FY 2002 Annual Performance Plan.

¹⁴ The number of selections analyzed differed from the selections reviewed previously due to the information available.

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**EP's reliance on Local Classified Issues examinations
when expected determination letter requests do not
materialize**

EP has anticipated a significant increase in the amount of resources needed to process requests for determination letters since FY 1998 based on changes in laws affecting employee benefit plans. Accordingly, EP has allocated more resources to the Determination Letter Program and fewer resources to the Examinations Program. When the volume of determination letter requests was not as high as anticipated, EP shifted resources back to the Examinations Program and has increasingly relied on the Local Classified Issues category in assigning work to examiners. Table 3 illustrates the affect on the Local Classified Issues category when the expected amount of determination letters did not materialize.

**Table 3. Comparison of Planned vs. Actual Workdays
(Fiscal Years)**

	1999	2000	2001
Planned Workdays for Determinations	38,814	39,721	41,109
Actual Workdays for Determinations	28,161	25,103	25,228
Planned Workdays for Local Classified Issues	1,573	7,831	13,910
Actual Workdays for Local Classified Issues	7,206	18,914	26,053

Source: EP Function Technical Time Reports

In FY 2002, the EP function initiated additional research projects after it learned that determination letter receipts would be delayed. These four Compliance Research projects were based on a risk assessment conducted in FY 2001. Even though EP has undertaken these new compliance initiatives, the Local Classified Issues category is still a large part of the Examinations Program.

The amount of time budgeted for the Local Classified Issues category for FY 2002 was 8,858 workdays. As of mid-year,

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EP exceeded this amount by spending 9,397 workdays on these types of examinations. If EP continues to work Local Classified Issues at this pace for the remainder of the year, it will spend nearly 19,000 workdays conducting these types of examinations.

The Director, EP Examinations stated that he foresees the Local Classified Issues category as being a small part of future workplans as EP Examinations progresses towards a market segmentation approach. He added that this category will not drive future workplans but will remain as a training tool for future agents.

Until the Local Classified Issues category becomes a small part of future workplans, we believe that EP needs to institute procedures to ensure these types of examinations are effective in helping EP meet its mission of identifying and correcting noncompliance.

Recommendations

The Commissioner, TE/GE Division, should:

1. Issue guidance clarifying the expectation for the Local Classified Issues category of examinations to ensure returns selected further EP Examinations' mission to identify and correct noncompliance.

Management's Response: In order to ensure that returns selected for examination have a high probability of noncompliance, TE/GE management implemented a new process called the Risk Assessment Program. A key part of the program includes refinement of their methodology for selecting returns for examination by using the compliance history of both individual taxpayers and market segments. Returns are no longer being selected using the Local Classified Issues category. TE/GE management has actively engaged the services of their Research and Analysis staff in this process to ensure that returns with the highest probability for noncompliance are selected for examination.

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2. Develop formal procedures to ensure that, periodically, condition codes are properly added (when there are indications of noncompliance) or removed (when previous examinations do not indicate an area of noncompliance) from the Local Classified Issues category of examinations to achieve the goal(s) established in Recommendation 1.

Management's Response: TE/GE management is no longer using the Local Classified Issue category of examinations. They are continually updating the risk assessment data and will change their examination focus when warranted, based on the results of examinations.

3. Add language to future workplan guidelines to ensure that employee benefit plans covering the greatest number of participants are selected for examination when all other selection criteria are equal.

Management's Response: TE/GE management will include a comment in the FY 2003 workplan guidelines on how they will use the number of participants in the selection of returns for examination.

**Including Scenarios Can Be
Integral in Developing Flexible
Future Workplans**

The EP Examinations' workplan does not include various scenarios¹⁵ upon which to base the selection of additional returns when examination resources are not used to process determination letters. This condition existed because the workplan was structured to support the volume of determination letter receipts and did not contain alternatives if the volume did not materialize. For example, prior to FY 2001, the EP function anticipated that determination letter receipts would total 100,000. As a result, the FY 2001 workplan assumed these projected receipts in allocating staffing resources and did not consider other alternatives. When these projected receipts did not materialize, the EP function allocated its available examination resources to conducting Local Classified Issues examinations. As we

¹⁵ Scenario is defined as an outline for any proposed or planned series of events. Scenario planning is an approach whereby alternatives are presented.

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have previously shown, these examinations are not an effective use of EP's resources.

According to the General Accounting Office standards for effective internal controls, management should identify and analyze risks that could impede the efficient and effective achievement of program objectives. This includes identifying any risks inherent to the nature of the program's mission or to the significance and complexity of any activities it undertakes. The EP function's management should include in the EP Examinations' workplan different options or scenarios in case examination resources are not needed to process determination letters during the year. The scenarios should identify how available resources should be directed to examinations that will help accomplish the mission of the program.

The EP function has historically overestimated the number of determination receipts expected because planning for the number of receipts is an imprecise science. The EP function tries to estimate how many employers or plan sponsors will request a determination letter. It has erred on the conservative side, preferring to commit resources upfront to process determination letters rather than trying to reassign examiners in the middle of an examination to process determination letters as they are received.

Table 4 illustrates the planned and actual determination letter receipts for FYs 1999 through 2001 and the effect on the Examinations Program when the expected receipts did not materialize.

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**Table 4. Impact of Determination Receipts
on the Examinations Program**

	FY 1999	FY 2000	FY 2001
Determination Letters Expected	216,300	70,000	100,000 ¹⁶
Determination Letters Received	37,177	27,005	30,492
Planned Direct Examination Workdays	40,386	31,013	34,964
Actual Direct Examination Workdays	53,498	50,271	48,854

*Source: EP Function Management Information Reports and
Workplans*

The EP function acknowledges that its workplans must be flexible to adjust for significant changes, especially a shortfall, in the timing or number of determination receipts received during the year. For example, EP revised the FY 2001 workplan at mid-year because EP management realized their methodology for estimating the timing of receipts incorrectly assumed the increase would begin earlier and progress ratably throughout the fiscal year. As a result, approximately 13,000 workdays were reprogrammed into the Local Classified Issues category. According to EP Examinations staff, this was done because these examinations result in a quick turnaround time, thereby providing a smooth transition later in the year if a sudden

¹⁶ The volume was estimated because the GUST remedial amendment period expired on December 31, 2001. GUST is a term used to collectively refer to a group of tax laws: The Uruguay Round Agreements Act, Pub. L. 103-465; the Uniformed Services Employment and Reemployment Act of 1994, Pub. L. 103-353; the Small Business Job Protection Act of 1996, Pub. L. 104-188; the Taxpayer Relief Act of 1997, Pub. L. 105-34; the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.); and the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554.

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increase in requests for determination letters required movement of the examiners back to processing determination letters. However, the increase did not materialize and the resources were spent conducting Local Classified Issues examinations the rest of the year.

During FY 2002, EP management implemented additional research projects when determination letter requests did not materialize as anticipated. The FY 2002 EP Examinations' workplan was developed assuming determination receipts of about 145,000. Accordingly, EP budgeted 63 percent of examination resources to assist in processing these determination receipts. In November 2001, the Manager, EP Examination Programs and Review, issued a memorandum notifying the EP Area Office Managers of a temporary respite from determination receipts. Based on this information, EP Examinations allocated these available resources to four new market segment research projects, in addition to conducting Local Classified Issues examinations. The memorandum also contained guidance on the priority of assigning new casework and indicated that EP was prepared to target other market segments if additional examination resources became available.

In addition, the Director, EP issued an all employee memorandum in February 2002 indicating that the overall volume of requests for determination letters remained much lower than anticipated for the year. However, EP did not revise the workplan at that time to reflect this change. Although EP Examinations implemented some interim measures in FY 2002 to address the initial shortfall in receiving requests for determination letters, these measures were reactive in nature and were not specified in the workplan guidelines. In addition, these measures did not ensure that EP would no longer rely primarily on Local Classified Issues examinations. As we have previously shown, EP is still projected to spend nearly half of its examination resources during FY 2002 conducting Local Classified Issues examinations.

In our opinion, the consideration of various scenarios during the annual planning process can assist EP in focusing more

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of its resources on identifying and correcting noncompliance. This can ensure the effectiveness of its Examinations Program by establishing priorities for work set aside as a result of fluctuations in resource commitments to the Determination Letter Program.

Recommendation

4. The Commissioner, TE/GE Division, should ensure that future examination workplans incorporate various scenarios to direct available examination resources into areas that achieve the EP Examinations' mission of identifying and correcting noncompliance when anticipated determination letter receipts do not materialize.

Management's Response: In the event that planned determination receipts do not materialize, TE/GE management will be able to select returns under the Risk Assessment Program. TE/GE management is also attempting to change the determination letter process to improve the flow of applications. Further, TE/GE management is considering establishing a dedicated workforce to process determination letters, which would simplify the process of developing the examinations workplan.

The Long Term Employee Plans Function's Examinations Strategy Is to Incorporate a Market Segmentation Approach to Achieve Its Mission of Identifying and Correcting Noncompliance

In future years and after the current determination letter "crunch," the Director, EP Examinations, envisions changing the planning process by moving into more specialized work and away from general examinations, such as Local Classified Issues. He wants the program to incorporate a market segmentation approach of auditing similar types of benefit plans to learn more about the compliance risks in each market segment. It would also enable the EP function to provide better service to its customer segments and address emerging market segments that have the greatest impact on participants' retirement benefits.

To accomplish this change in the planning strategy, the EP function revamped the Compliance Research Program and commenced three national research projects under this

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program in FY 2001.¹⁷ The projects are designed to define the employee benefit plans universe by conducting research samples and using the results from these samples to profile compliance levels in the applicable market segments. The goal of this program is to continually build information and knowledge about the level of compliance within the various market segments of the employee benefit plans universe in order to direct compliance activities to areas of known or potential noncompliance.

Three additional compliance research projects, Simplified Employee Plans Adopters, Third Party Administrators, and Non-Filers were proposed for FY 2002. However, because of the expected influx of requests for determination letters, the EP function did not expect to begin these projects during the year. The Director, EP Examinations, hopes to have the resources available in the future to conduct seven to eight of these types of research projects each year.

The current Compliance Research Program differs from the program in prior years because these current projects are to contain statistically reliable samples that will allow the EP function to determine a baseline (the level of compliance based on prior completed examinations) of compliance within each market segment. The baseline information will be used to direct and assess the impact of future compliance activities by reviewing their effect (i.e., whether plans have a higher or lower level of compliance as a result of the market segmentation approach) against this baseline level of compliance. In addition, the current projects will be more national in scope than those conducted in the past.

If current projects identify an area of noncompliance, the EP function plans to first emphasize outreach efforts (publish documents, speeches, etc.) by CE&O educating taxpayers that may not be in compliance. EP management believes this approach would be more effective and efficient in “getting the word out” than by conducting individual examinations. Management plans to incorporate high

¹⁷ These are research projects on Multiemployer plans, I.R.C. 403(b)/457 plans, and I.R.C. 401(k) plans.

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noncompliance areas into future examination workplans. We see value with this approach, as long as it also provides an effective enforcement presence to ensure that outreach efforts were successful in addressing the identified areas of noncompliance to complement the Compliance Research Program. The EP function needs to effectively use the results from its Compliance Research Program to ensure areas of noncompliance are addressed.

The EP function conducted a risk assessment in FY 2001 to identify market segments and associate a level of risk¹⁸ and reliability¹⁹ to them. This risk assessment profiled the EP universe based on plan year 1998 filings. For each segment within the universe, the EP function researched historical examination information on the RICS and determined the statistical reliability (number of prior examinations) and risk (no change percentage) associated with each. The Director, EP Examinations, sees the information obtained from this assessment as being a primary tool in deciding future compliance projects and studies.

In the past, the EP function did not effectively learn from and follow through on the results from their research projects. This is evidenced by the amount of general work, such as Local Classified Issues, conducted by EP in recent years after years of doing research projects. For example, EP conducted approximately 28,000 research examinations during FYs 1997 through 2001. We could not identify any significant changes in their allocation of examination resources towards areas of noncompliance that resulted from these projects. EP management acknowledged that they did not adequately analyze the data from past market segmentation efforts. This included not gathering sufficient information to refine their market segments.

¹⁸ Each market segment category was ranked "high," "medium," or "low" risk. A "high" risk assessment was assigned to segments that were determined to have the greatest chance of noncompliance.

¹⁹ Each market segment category was also ranked as to statistical assessment reliability and was noted as "high," "medium," or "low." A "high" reliability would be assigned to those segments where a relatively high percentage of plans were audited.

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It appears that current efforts can be successful as long as EP incorporates, as planned, the results of research projects into future examination workplans so that examination resources are directed at achieving EP Examinations' mission of identifying and correcting noncompliance.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to assess the effectiveness of the Employee Plans (EP) function's examination planning process. To accomplish our objective, we interviewed applicable EP executives, managers, and staff. We also analyzed data available through EP's management information reports for Fiscal Years (FY) 1997 through the first half of FY 2002. However, we did not verify the accuracy of the data obtained from EP's management information reports.

- I. Determined how EP Examinations would ensure adequate audit coverage and effectively manage their resources if actual determination letter applications fell short of their projected amount.
 - A. Interviewed EP and EP Examinations management and determined:
 - 1. The degree of coordination between EP Examinations and Rulings and Agreement staff regarding expected determination letter receipts.
 - 2. If EP Examinations implemented monitoring procedures identifying the effect on program resources as a result of expected determination letter receipts.
 - 3. The process for capturing and providing information to management regarding the expected volume of determination receipts.
 - 4. The degree of coordination between EP and EP Examinations management regarding determination letter receipts.
 - B. Interviewed the Manager, Examination Planning and Programs (EPP) and staff and determined the process for revising the workplan once a significant variance (especially a shortfall) in the receipt of determination letter applications was identified.
 - C. Interviewed the Director, EP Examinations and determined if EP Examinations has an action/contingency plan in place detailing how they will deploy additional resources resulting from a shortfall in determination letter receipts.
 - D. Evaluated the adequacy of the contingency plan in the previous step in ensuring that the overall objectives of the Examinations Program are met.
 - E. Determined how the processing of determination letters has historically (FYs 1998 through 2001) impacted the Examinations Program. For each year, we obtained and reviewed the EP guidelines, workplan, accomplishment and technical time reports and:

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1. Identified the amount of determination letters that were expected and ultimately received.
 2. Determined the amount of budgeted and actual staff days allocated to process determination letters and conduct examinations.
 3. Determined how each examination category was affected by the amount of determination letters that were received.
- II. Determined if the EP Examinations' workplan focused on known areas of noncompliance and specific areas so the extent of noncompliance could be developed through examinations.
- A. Obtained the FYs 1998 through 2002 EP Examinations guidelines and workplans and reviewed and compared them to identify changes in program direction, if any.
 - B. Obtained and reviewed EP accomplishment reports for FYs 1997 through the first half of FY 2002 to identify areas with high and low no change rates.
 - C. Interviewed the Manager, Classification; Manager, EPP and various staff; and a Classification Specialist and determined if EP Examinations has performed a trend analysis, by condition codes, to determine the cause of the high no change rates in the Local Classified Issues category.
 - D. Interviewed the Director, EP Examinations; the Manager, Classification; and the Manager and various staff of EPP and determined how they will utilize the results of the market segment risk assessment to improve examination selection criteria.
 - E. Interviewed Area Office Managers and determined the procedures for selecting returns from the project code 301, Local Classified Issues, category.
 - F. Obtained a computer download of 84,552 records of pension plan examinations created and/or disposed of between October 1, 1996, and December 31, 2001, from the Base Inventory Master File (BIMF) to determine the appropriateness of recent selections from the Local Classified Issues category.
 1. Reviewed all 6,994 and 1,454 Local Classified Issues examination selections by condition code¹ for FY 2001 and the first quarter of FY 2002, respectively.

¹ A total of 88 (85 for FY 2001 and 3 for the first quarter of FY 2002) were not considered in our analysis because the condition code field was blank or outside the series of codes associated with Local Classified Issues. These represented examination selections. In some cases, the examinations were still open at the time of our review.

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2. Reviewed the results of all 4,441 completed Local Classified Issues examinations,² by condition code, and determined if the results supported the selections made during FY 2001 and the first quarter of FY 2002.
 3. Obtained and matched the participant data to the FYs 2001 and 2002 examination selections identified in step II.F.1. and determined the number of participants affected by these examination selections.
- G. Analyzed the 17 current condition codes used to select project code 301, Local Classified Issues, examinations and determined if these condition codes contained specific issues or conditions to identify areas of noncompliance.
- H. Interviewed a Classification Analyst and determined how the project code 301, Local Classified Issues, category is monitored to ensure that the best returns are selected for examination.

² These completed examinations were of returns that were selected from the Local Classified Issues category between October 1, 1996, and September 30, 2001.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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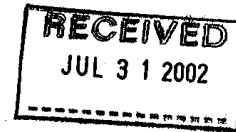
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
JUL 26 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

A handwritten signature in dark ink, appearing to be "Darlene R. Berthod".

Darlene R. Berthod, Acting Commissioner
Tax Exempt and Government Entities Division

SUBJECT:

Management Response to Draft Audit Report 200110051:
Additional Improvements Will Better Focus the Employee Plans
Function's Examination Workplan on Areas that Identify and
Correct Noncompliance

I have reviewed your draft report on the effectiveness of the Employee Plans (EP) examination planning process. Your review of the Fiscal Year 2002 EP Examination workplan found that, with the exception of the Local Classified Issues category, we had structured the workplan to enable EP to identify and correct compliance within employee benefits plans.

I agree with many of your comments in the report on the Local Classified Issue category, and we have ceased identifying and selecting new returns under that program. However, we will complete the examinations that are already in process in this category.

In place of the Local Classified Issue category, we have begun a formal Risk Assessment Program. We ranked market segments as "high," "medium," or "low" risk based on prior examination results. We view this method of selecting examinations as more effective in helping EP meet its mission of identifying and correcting noncompliance. Your review of the Local Classified Issue category gave us observations and recommendations that we intend to implement in the Risk Assessment Program. In addition, your observations on other areas of EP examination planning were valuable.

Our comments on the specific recommendations in the report are as follows:

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Recommendation 1:

The Commissioner, TE/GE, should issue guidance clarifying the expectation for the Local Classified Issues category of examinations to ensure returns selected further EP's mission to identify and correct noncompliance.

Assessment of Cause:

At the time of the review, the TIGTA determined that the EP Examination workplan did not ensure that EP's discretionary examination work (primarily the Local Classified Issues category) was effective in identifying and correcting noncompliance.

We established the Local Classified Issue category of selecting returns for examination as an interim program designed to consolidate several local methods of selecting returns. We were still developing the program when management decided to pursue a Risk Assessment approach to selecting returns.

Corrective Action:

Completed.

In order to ensure that returns selected for examination have a high probability of noncompliance, we implemented a new process called the Risk Assessment Program. A key part of the program includes refining our methodology for selecting returns for examinations by using the compliance history of both individual taxpayers and market segments. We are no longer using the Local Classified Issue category. We have actively engaged the services of our Research and Analysis staff in this process to ensure that we select returns with the highest probability of noncompliance for examination.

Implementation Date: Completed. (January 1, 2002)

Responsible Official: Not applicable

Corrective Action Monitoring Plan: Completed

Recommendation 2:

The Commissioner, TE/GE, should develop formal procedures to ensure that, periodically, condition codes are properly added (when there are indications of noncompliance) or removed (when previous examinations do not indicate an area of noncompliance) for Local Classified Issues category of examinations to achieve the goal(s) established in Recommendation 1.

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Assessment of Cause: See Recommendation 1

Corrective Action:

Completed.

We are no longer using the Local Classified Issue category of examinations. We are continually updating our risk assessment data and will change our examination focus when warranted, based on the results of our examinations.

Implementation Date: Completed

Responsible Official: Not applicable

Corrective Action Monitoring Plan: Completed

Recommendation 3:

The Commissioner, TE/GE, should add language to future workplan guidelines to ensure that employee benefit plans covering the greatest number of participants are selected for examination when all other selection criteria are equal.

Assessment of Cause: We generally agree that selecting returns for examination that cover the greatest number of participants is important. However, we must maintain an appropriate balance of types and size of plans. The grade levels of our agents and resource availability also have a direct impact on the types and size of plans we can select for examination. In addition, the Advisory Committee on Tax Exempt and Government Entities (ACT) recently recommended that we direct additional compliance efforts toward "small businesses."

Corrective Action:

The FY 2003 workplan guidelines will include a comment on how we will use the number of participants in the selection of returns for examination.

Implementation Date: October 1, 2002

Responsible Official: Director, EP Examinations

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Corrective Action Monitoring Plan:

We will monitor this corrective item through the Business Performance Review Process of the Commissioner of Internal Revenue and the Inventory Tracking and Closure system of the Treasury Department.

Recommendation 4:

The Commissioner, TE/GE, should ensure that future examination workplans incorporate various scenarios to direct available examination resources into areas that achieve EP Examinations' mission of identifying and correcting noncompliance when anticipated determination receipts do not materialize.

Assessment of Cause:

At the time of the review, the TIGTA found that the EP Examination workplan did not address how to select additional returns when we do not use examination resources to process determination letters.

If planned determination receipts do not materialize, we will be able to select returns under the Risk Assessment Program. Please note that EP is attempting to change the determination letter process to improve the flow of applications. We announced ten possible long-term options to the public on August 8, 2001, and invited the public to comment on them by June 30, 2002. We now have received and are reviewing the public comments. We will finish our review in August 2002. The adoption of any of these options will assist us with our examination planning.

Further, the establishment of a dedicated workforce to process determination letters would simplify the process of developing a comprehensive examination plan. This recommendation is also under consideration.

Corrective Action: We will decide whether we should adopt any of the options to improve the flow of determination applications. We also will decide whether to establish a dedicated workforce to process determinations letters.

Implementation Date: October 1, 2002

Responsible Official: Director, EP Examinations

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Corrective Action Monitoring Plan:

We will monitor this corrective item through the Business Performance Review Process of the Commissioner of Internal Revenue and the Inventory Tracking and Closure system of the Treasury Department.

If you have any questions, please contact Preston Butcher at (410) 962-4092.